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No. 392

IN THE

Supreme Court of the United States

OCTOBER TERM, 1964

SIDNEY C. KLEINMAN and JANICE R. KLEINMAN,
Objectors-below, Petitioners,

vs.

HYMAN SAMINSKY and BETTY SIEGEL, Trustee for JOAN C. SIEGEL,
Plaintiffs-Respondents,

and

CHARLES C. ABBOTT, WILFRED GODFREY, J. LEE POTTER, ORA C. ROEHL, ERWIN H. SCHELL, SIDNEY L. SHOLLEY, CAMERON S. THOMPSON, SAM G. BAGGETT, GLENN N. LEMPEREUR, KEYSTONE CUSTODIAN FUNDS, INC., KEYSTONE CUSTODIAN FUNDS, INC., as Trustee, and THE KEYSTONE COMPANY OF BOSTON,
Defendants-Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF DELAWARE.

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PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF DELAWARE.

To the Justices of the Supreme Court of the United States:

Petitioners, Sidney C. Kleinman and Janice R. Kleinman, respectfully petition for a writ of certiorari to review the judgment of the Supreme Court of Delaware entered April 22, 1964.

OPINIONS BELOW.

The opinion of the Court of Chancery of Delaware is reported at 194 A.2d 549 (1963) and is printed in the Petitioners' Appendix below, p. 63. The opinion of the Supreme Court of Delaware is reported at 200 A.2d 572 (1964) and is printed in the Appendix to this petition at p. 1a.

Another opinion of the Chancery Court which is related to this case but not directly relevant here is reported at 185 A.2d 765 (1961).

JURISDICTION.

The judgment of the Supreme Court of Delaware was entered on April 22, 1964. A timely petition for rehearing was denied on May 19, 1964.

The jurisdiction of this Court to entertain the petition for a writ of certiorari is based on 28 U.S.C. § 1257(3).

QUESTIONS PRESENTED.

Do the provisions of the Investment Company Act for independent directors and protection against self-dealing and conflict of interest between investment companies and their managers—and more particularly the requirements that at least 40% of the board of directors of a registered investment company be independent of or unaffiliated with the company's "investment adviser" and that investment advisory contracts be approved by a majority of the independent directors and the investors of the company—apply to a registered investment company organized as a common law business trust and its corporate trustee, which trustee serves also as the depositor and investment adviser of the company and whose directors are also the directors of the

investment company? The court below held that the investment adviser was exempt as such as a trustee under §2(a)(19) of the Act.

STATUTE INVOLVED.

The pertinent provisions of the Investment Company Act of 1940, 15 U.S.C. 80a-1, *et seq.*, are set forth in the Appendix, pp. 10a-14a.[1]

STATEMENT.

This case concerns the application of the Investment Company Act to approximately one-fourth of the investment companies subject to registration under the Act, and particularly to the Funds involved here which have assets exceeding three-fourths of a billion dollars and more than 230,000 investors.

The action was commenced on August 2, 1960, when Hyman Saminsky on his own behalf and representatively on behalf of all other holders of certificates of participation of the Funds filed a complaint in the Court of Chancery in New Castle County, Delaware. The Funds are a series of ten common law trusts, registered under the Act and are commonly known as "open-end" mutual

[1] The Investment Company Act is contained in 15 U.S.C. 80a-1, *et seq.* The numbering of the first 28 sections of the Act is the same in both the Act and the Code. Section 29 of the Act, an amendment of the Bankruptcy Act, does not appear in 15 U.S.C. Hence Section 30 of the Act is § 80a-29 etc.

funds (PA 16, 17).[1] The individual defendants are, *inter alia*, directors of defendant Keystone, a Delaware corporation, trustee of and investment adviser to the Funds (PA 17). The defendant The Keystone Company of Boston, a Delaware corporation ("Keystone of Boston"), is a wholly-owned subsidiary of Keystone and is the sole underwriter of certificates of participation in the Funds (PA 17).

The complaint as finally amended and supplemented on March 29, 1963, charges that defendants had committed waste of assets of the Funds, in that management fees and recurring charges were excessive and a spoliation of Funds' assets; that defendants had breached the fiduciary duty owed to plaintiffs by self-dealing with respect to the awarding of the underwriting contract to Keystone of Boston (a wholly owned subsidiary of Keystone), that excessive fees had been charged and accepted by Keystone for investment advisory services, that Keystone had engaged in the practice of "reciprocals" with respect to the awarding of brokerage business; that the underwriting contract and advisory fee schdule and contract had not been submitted to the certificateholders as required by the Act; and that certain other violations of law had been committed by defendants (PA 16-25). The complaint specifically charged that defendants violated §§1(b)(2), 10, 15, 17(h)(i), 36 and 37 of the Act (PA 21).

The Funds were established on July 15, 1935, by the execution of identical trust agreements or declarations of trust (DA 1-18). By the terms of the trust agreements, Keystone maintains complete control over investment

[1] Citation to the Record-Appendices below of objectors-petitioners and defendants-respondents is "PA" and "DA," respectively. Citation to the Appendix to this Petition is "App."

policy and performs all necessary services as an investment adviser and all the clerical work for the Funds. For example, the trust agreements require that Keystone shall:

1. receive the cash and securities of the Funds and the proceeds from the sale of certificates and deposit them with a custodian (Art. I, Sec. 1; Art. II, Sec. 1(a); DA 3, 8);

2. determine the manner in which the Funds' assets shall be invested and what securities shall be bought and sold (Art. I, Secs. 8-10; Art. II, Sec. 1(b); DA 6, 8);

3. arrange for the continuing supervision of the Funds and exercise all rights of owners with respect to securities included in the Funds (Art. II, Sec. 1(d); DA 8); and

4. maintain proper accounting records and prepare all reports and tax returns as may be required under state and federal law (Art. II, Sec. 1(i)-(1); DA 8-9).

Clearly, under these trust agreements, Keystone, at one and the same time, is the trustee, depositor and investment adviser of the Funds.

Under the trust agreements Keystone charges the Funds for its services a management fee of ½ of 1% per annum of the first $150,000,000 of assets of the Funds and 3/8 of 1% per annum of assets in excess of $150,000,000. In addition Keystone receives a so-called "recurring charge" of ¼ of 1% per annum of the net asset value of the Funds. The "recurring charge" is stated to be in lieu of all expenses of operations of the Funds, except the management fee and taxes[1] (DA 4). From 1954 to 1962 Keystone

[1] In Saminsky v. Abbott, 185 A. 2d 765 (Del. Ch., 1961), discussed below, the chancery court determined that the excess of recurring charges over actual expenses constituted additional management fees.

received from the Funds recurring charges of $9,342,087 and management fees of $15,820,898 or a total of more than $25,000,000. In 1962 alone, Keystone received a recurring charge of $1,644,891 and a management fee of $2,652,026 based on net assets of $677,768,800 (PA 18, 19). In June, 1963, net assets of the Funds exceeded $771,000,000 and there were more than 230,000 holders of certificates of participation (PA 64).

The individual defendants, who are the directors of Keystone, act also as directors of the Funds (PA 9, 11-15; DA 13). The individual defendants regularly pass upon additions to and eliminations from the portfolio of each fund; dividend distributions; selection of independent accountants; recommendations to certificateholders as to amendments of the contract; proxy statements distributed to certificateholders; registration under the Securities Act of 1933 and state blue sky laws; detailed financial statements for each fund; and reports on economic and business outlook as related to porfolio transactions (*Ibid.*).

Subsequent to filing answers to the first amended complaint, defendants moved for summary judgment on November 4, 1960. On September 18, 1961, the chancellor granting the motion in part and denying it in part, held, *inter alia*, that the underwriting contract between Keystone of Boston and Keystone was void under §46(b) of the Act because it had not been approved by the Funds' investors as required by §15(b)(1) of the Act (*Saminsky* v. *Abbott*, 185 A. 2d 765 (Del. Ch., 1961)).

While supplemental briefs pertaining to the summary judgment motion were under consideration by the chancery court, defendants called a meeting of the Funds' investors for the purpose of sanctioning the current and past underwriting agreements between Keystone and Keystone of Boston and also the payment of management fees and

recurring charges by the Funds to Keystone. Approval was obtained on January 18, 1963 (see 194 A.2d at 550-1; PA 30).

After approval and while the further matters concerning the motion for summary judgment were pending: (1) plaintiffs filed their final amended and supplemental complaint described above; (2) defendants answered; and (3) plaintiffs and defendants agreed upon and submitted to the chancery court a plan of settlement of the action.

Pursuant to Rule 23, Delaware Chancery Rules, notice was given certificateholders of the Funds for a hearing on the fairness, reasonableness and adequacy of the plan of settlement (PA 31-40). Petitioners as certificateholders of one of the Funds, filed their Notice of Intention to Appear, Statement of Position, attended the settlement hearing, and presented evidence and argument to the Chancellor in opposition to the plan of settlement (PA 40-63).

One of the petitioners' objections was that the proposed settlement perpetuated a violation of the Act in that it permitted the Funds to continue to operate with no directors who were independent of Keystone (PA 43, 46-8).

In approving the settlement agreement the court of chancery specifically overruled this objection (194 A.2d at 551; PA 66-7). The court assumed there was a continuing conflict of interest but that this conflict was not proscribed by the Act (*Ibid*).

Petitioners, who were the only objectors, appealed to the Supreme Court of Delaware. That court held that the Funds and Keystone were exempt from the requirement of independent directors under §§10 and 15 of the Act because Keystone was not an investment adviser. The court reached this conclusion in the following manner (200 A. 2d at 576; App. 6a-7a):

> "Next, appellants argue that since the Funds as such had no board of directors and since the directors

of Keystone, the trustee, performed the functions of a board of directors of the Funds, it follows that the individual defendants are at one and the same time directors of the investment adviser, Keystone, and of the Funds in violation of §10(a) of the Act which prohibits more than 60% of such a board from being 'affiliated' with the investment adviser. It is therefore argued that the complaint set forth a valid enforceable claim under the Act which was improvidently given up by the settlement.

"In the first place, Keystone is not the investment adviser of the Funds. It is the trustee. As such, therefore, it is exeluded in terms from the statutory definition of an investment adviser found in §2(a)(19) of the Act. Furthermore, there is in existence no investment advisory contract between Keystone and the Funds which, under §15(a) of the Act, must by law be approved by a majority of the shareholders.

"In the second place, since the Funds do not have an investment adviser within the meaning of the Act, it follows that there is none with whom directors of the Funds could be 'affiliated' within the prohibitory limits of §10(a) of the Act. Furthermore, it is obvious to us that the relationship between Keystone and the Funds and its certificate holders is that of trustee and beneficiary. The propriety of this relationship under the Act seems to be recognized by §16(b).

"The whole of appellants' argument based upon the Act seems little more than an attempt to distort the true nature of the Funds and Keystone into a mold which would fit neatly into one of the prohibited areas of the Act. The difficulty is, however, that the argument in reality is a complaint that the Congress did not pass the Act in a form more acceptable to appellants."

Based on this erroneous construction of the Act, the Delaware Supreme Court affirmed the approval of the settlement agreement and thereby perpetuated a continuing violation of the Act. It is from the judgment based on this opinion that the petition for certiorari is filed.

REASONS FOR GRANTING THE WRIT

1. The Court Below Erroneously Decided a Substantial Federal Question.

The Delaware Supreme Court has erroneously decided a substantial question of federal law which has not been, but should be, decided by this Court. The Investment Company Act of 1940 requires that investment companies and their investors be insulated against overreaching by management and advisers. Among the various protections against self-dealing is the requirement that investment companies have at least a minority of directors independent of the investment adviser. Do these and other related provisions apply to the Funds and Keystone? Keystone created the Funds as a common law business trust and appointed itself as sole trustee of the Funds. Keystone serves as their depositor, directs their investment and otherwise performs all of the functions and duties of an investment adviser and receives substantial fees for such services. Keystone's directors are also the directors of the Funds.

The court below held the Act's provisions against self-dealing inapplicable by construing §2(a)(19)(A) of the Act to exclude Keystone as an investment adviser because it is a "trustee". We think the Delaware Supreme Court plainly misconstrued the Act.

Based on this misconstruction, the court below concluded that §§10 and 15 of the Act were inapplicable (200 A. 2d at 576; App. 6a-7a) even though in these provisions Congress went to great "pains • • • to insure an adequate representation by independent directors". *Brown* v. *Bullock*, 294 F. 2d 415, 421, n. 3 (C.A. 2, 1961).

Section 10(a) and (h) was designed to protect against overreaching by those in control of investment companies

by requiring that at least 40% of the directors of the company or the depositor of the company be independent of the directors of the adviser. Similarly, §15(a), (c), (d) and (e) was designed to prevent overreaching in relation to investment adviser fees and agreements by providing for their periodic scrutiny and approval by a majority of independent directors and the investors.

By its determination that Keystone is a trustee and hence not the Funds' investment adviser the court below approved a settlement of the litigation which bars forever to 230,000 public investors, who have invested in the Funds over $770,000,000.00, the protection of disinterested directors that Congress plainly intended such investors to have.

Moreover, the decision below, if permitted to stand, will deprive an even larger segment of the investing public of these protections against self-dealing and conflict of interest. A recent, exhaustive and authoritative study found that approximately one-fourth of the open-end investment companies studied are organized as trust entities and that these trusts hold about one-fourth of the assets of the mutual fund industry. *A Study of Mutual Funds*, Prepared for the Securities and Exchange Commission by the Wharton School of Finance and Commerce, H. Rep. No. 2274, Comm. on Interstate and Foreign Commerce, 87th Cong., 2d Sess. (1962), p. 6.

Had Congress wished to exclude from the Act's protection such a large segment of investment companies and public investors, it would have said so plainly. If the decision below is correct, the Act may be evaded today simply by creating investment companies in the form of common law trusts and by naming a "trustee" to perform all of the functions of the investment adviser.

But Congress found and declared in §1(b) of the Act:

> "• • • that the national public interest and the interest of investors are adversely affected—
>
> • • •
>
> "(2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, • • • rather than in the interest of • • • security holders; • • •."

Congress further stated that it is the "policy and purposes" of the Act "to mitigate and, so far as it is feasible, to eliminate" the abuses enumerated and that the Act "shall be interpreted" in accordance with such policy and purposes (*ibid.*).

The Investment Company Act of 1940 went far beyond the earlier federal securities acts, which were primarily disclosure statutes, since Congress concluded that mere disclosure legislation would not provide adequate protection to investment company shareholders. See S. Rep. No. 1775, 76th Cong., 3d Sess., pp. 11-12; H. Rep. No. 2639, 76th Cong., 3d Sess., p. 10. Congress provided for detailed regulation of virtually all aspects of the investment company industry. It carefully specified the duties and obligations of persons who, through their participation in and affiliation with investment company management and operation, control the vast assets possessed by these companies. Specifically, in §§10 and 15, Congress implemented its findings by providing some independence —a buffer—between the investors and the company on

one hand and those in control of the company on the other.[1]

Although "trustee" is not defined expressly in the Act, this Court has said with respect to securities legislation: "* * * that courts will construe the details of an act in conformity with its dominating general purpose, will read text in the light of context and will interpret the text so far as the meaning of the words fairly permits so as to carry out in particular cases the generally expressed legislative policy." (*S.E.C.* v. *C. M. Joiner Leasing Corp.*, 320 U.S. 344, 350-1 (1943).) See also *American Power and Light Co.* v. *S.E.C.*, 329 U.S. 90, 104 (1946).

In construing §2(a)(19) of the Act the court below did not even pay lip service to the overriding purpose and design of the Act. It made no attempt to gather the meaning of "trustee" in the "light of context" or "legislative policy" as directed by this Court in *Joiner*. If it had, it would have found that "trustee" did not include a person who exercised all the powers and functions of an investment adviser. The "trustee" exemption was included for quite a different purpose—it was intended simply to

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[1] With respect to §10(a) defendants concede that the directors of Keystone are the directors of the Funds (PA 9, 11-15; DA 13). Whether these directors constitute the "board of directors" of the Funds within the meaning of §10(a) is immaterial because of §10(h)(1). Read together these sections require that "no depositor of a registered investment company shall have a board of directors more than 60 per centum of the members of which are persons who are investment advisers of, affiliated persons of an investment adviser of * * * such registered company." Here Keystone is the depositor as well as the adviser, and the board of directors of the depositor is identical to that of the adviser.

exclude individual members of a board of trustees of an investment company, as such. If it applies at all to a corporate trustee-creator of an investment company, it applies only to a "naked" trustee or custodian who has no responsibility for operations.

Section 2(a)(19) reads as follows:

> "'Investment adviser' of an investment company means (A) any person (other than a bona fide officer, director, trustee, member of an advisory board, or employee of such company, as such) who pursuant to contract with such company regularly furnishes advice to such company with respect to the desirability of investing in, purchasing or selling securities or other property, or is empowered to determine what securities or other property shall be purchased or sold by such company, * * *."

All of the persons mentioned in the parenthetical phrase, other than "trustee" are individuals who are part of the investment company family. Clearly, officers, directors and employees have this status. So do members of an advisory board. Under ordinary rules of construction, "trustee" being in the same class as individual officers, directors, members of an advisory board and employees, "trustee" must also be construed to mean an individual trustee. Moreover, as to such persons, Congress chose a regulatory scheme different from that applicable to "investment advisers." For example, directors must be elected by the investors (§16); officers must not constitute more than 60% of the board of directors (§10(a)); and members of an advisory board are subject to the same restrictions as the board of directors (§10(g)).

In light of the statutory pattern the meaning of "trustee" in the list of exemptions becomes clear: the trustee referred to is a member of a board of trustees which

board functions as a board of directors. Such an individual, performing the customary functions of a member of a board of trustees, was not to be deemed an investment adviser merely because of such membership. Congress was fully aware that investment companies were managed by boards of trustees as well as boards of directors (See §16(a)(b)).

The legislative history is also clear that in §2(a)(19) Congress did not include as "trustee" a trustee who exercised the powers of an investment adviser. On the contrary, the Senate Report on the bill that was enacted shows that Congress had in mind a passive trustee or custodian who had no responsibility for the operation of the trust funds. See S. Rep. No. 1775, 76th Cong., 3d Sess., pp. 8, 9-10. Reading the text of §2(a)(19) in the light of context it is clear that a "trustee" is not "bona fide" and acting "as such" when it is also exercising the powers of an investment adviser.

The court below erroneously interpreted "trustee" to include a corporate creator of the Funds which had designated itself as "trustee" with all the powers and duties of an investment adviser. In doing so it failed to read language in context and arrived at a result which nullifies the entire scheme of statutory protection designed to safeguard the investment company from its investment adviser.

Keystone, while in name a "trustee", exercises all of the powers and functions of an investment adviser as described specifically in §2(a)(19)(A). It has received and is receiving millions of dollars annually for performing the functions and services of an adviser. To hold that it is not an adviser because it is a "trustee" does violence to the Act.

Apparently not certain in its conclusion that Keystone is not an investment adviser because it is a "trustee," the court below held also that Keystone is not an adviser because there is no existing advisory contract (200 A. 2d at 576; App. 7a).

The written trust agreements which created the Funds expressly determine the functions and duties that Keystone is to perform for the Funds and sets forth the fees that Keystone is to receive from Funds for performing these functions and services (DA 4, 6, 8). As shown above these functions are precisely those of an investment adviser as defined in the Act. Patently, the trust agreement is also an investment advisory contract subject to the requirements of §15. Obviously the defendants thought so too since they sought and obtained investor approval of the fees paid under this agreement as a defense to this litigation (PA 30). In failing to construe the trust agreement as an advisory contract the court below again gave form precedence over substance and ignored the dominant purposes of the Act. This failure led the Court to the false conclusion that a majority of independent directors and a majority of investors are not entitled to pass upon the fees and other arrangements between Keystone and the Funds as required by §15 (a), (c), (d) and (e) of the Act (200 A. 2d at 576; App. 7a).

The facts in this case amply demonstrate the need for the full protection that Congress intended investors to have. Without independent representation among the directors, the Funds under the total domination of the investment adviser, have been required to pay advisory fees far in excess of a fair and reasonable amount. While the settlement approved below does reduce the fees to some extent, even the Chancellor acknowledged that the "benefits are not too great." (194 A.2d at 552; PA 68). If

the Funds had some directors independent of Keystone's directors, the investors might have obtained a more meaningful settlement. Indeed, had there been such independent directors this entire litigation might have been unnecessary.

In failing to require independent directors, the settlement falls far short of the relief to which the investors are entitled under the Act. The presence of independent directors will make supervision of the Funds' operations on a day-to-day basis, which no certificate-holder can hope to achieve, however diligent. "It is a well known fact that investors in mutual funds are primarily small shareholders. Very few of them have a sufficiently large financial interest in the management of the fund to risk any considerable sum on the outcome of litigation." *Chabot* v. *Empire Trust Co.*, 301 F. 2d 458, 461 (C.A. 2, 1962). The presence of such directors will make possible an independent voice in the determination of the advisory fees and the selection of securities and other significant questions relating to the day-to-day operation of the Funds. As a spokesman for investment advisers of investment trusts advised Congress in opposing the Act:

> "• • • from the point of actually running the fund, we find that our one independent director has a great deal of weight with us, and we hesitate, even with eight against one, when he feels strongly about a matter, to vote him down simply because we outnumber him. • • •
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> • • •
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> "• • • I think any firm of investment counsel would necessarily hesitate to follow an investment course opposed by independent minority directors, no matter how sound that course should appear." Hearings on S. 3580 Before a Subcommittee of the Comm. on Banking and Currency, 76th Cong., 3d Sess., p. 703.

The 230,000 investors in the Funds should not be deprived of this protection.

2. The Decision Below Is Not in Accordance With Applicable Decisions of This Court or Lower Federal Courts.

The Delaware Supreme Court rendered a narrow, grudging and pro forma interpretation of the Act, stating that petitioners' real complaint is that "Congress did not pass the Act in a form more acceptable to [investors]." (200 A.2d at 576; App. 7a).

In reaching that result the court below did not consider the only case decided (to our knowledge) by this Court with respect to the Act in question—a case that is controlling here, *S.E.C.* v. *Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959).

In that case, defendant argued, *inter alia*, that as an "insurance company" it was specifically excluded as an "investment company" by §§3(c)(3) and 2 (a)(17) of the Act. This Court, looking to substance and the dominant purpose of federal securities legislation, held that even though defendant was an insurance company the specific exemption was inapplicable because defendant was not issuing "insurance" but investment contracts. Even though there were strong policy reasons for exempting insurance companies—namely, that insurance companies are regulated traditionally by the states, the Court looked to the overriding federal policy. Mr. Justice Douglas noted the special requirements of the Investment Company Act (359 U.S. at 67, note 2) and in their concurring opinion Mr. Justice Brennan and Mr. Justice Stewart said (359 U.S. at 85-6):

> "• • • the detailed protections of the 1940 legislation—disclosure of investment policy, regulation of changes of that policy, of capital structure, conflicts

> of interest, investment advisers—all become relevant in an acute way here. These are the basic protections that Congress intended investors to have when they put their money into the hands of an investment trust; there is no adequate substitute for them in the traditional regulatory controls administered by state insurance departments, because these controls are not relevant to the specific regulatory problems of an investment trust."

While the Court did not there decide the specific question involved here, the principle enunciated is controlling. If it is erroneous to exempt as an investment company an insurance company issuing investment securities, it is also erroneous to exempt as an investment adviser a trustee that is performing all the functions and duties of an adviser. The decision below is out of harmony with the broad sweep and purposes of the Act as stated by Congress and this Court in the *Variable Annuity* case.

In every case before this Court arising under other federal securities laws this Court has uniformly held that the acts are to be broadly construed to give effect to their dominant purpose. With respect to the Investment Advisers Act of 1940, Title II to the Act in question, this Court held that Congress intended to prevent all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested and said:

> "Congress intended the Investment Advisers Act of 1940 to be construed like other securities legislation 'enacted for the purpose of avoiding frauds,' not technically and restrictively, but rather flexibly to effectuate its remedial purposes."

S.E.C. v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180 at 195 (1963).

See also *S.E.C.* v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943), *supra*, and *Deckert* v. *Independence Shares Corp.*, 311 U.S. 282 (1940) with respect to the Securities Act of 1933; and *J. I. Case Company* v. *Borak*, ... U.S. ...., 84 S. Ct. 1555 (1964) with respect to the Securities Exchange Act of 1934. The *Borak* case also makes clear that if *Brouk* v. *Managed Funds, Inc.*, 286 F. 2d 901 (C.A. 8, 1961), had not been vacated as moot, 369 U.S. 424 (1962), this Court would have reversed the *Brouk* decision which narrowly construed the Act to negate implied private rights of action under the Act. See also *Brown* v. *Bullock*, 294 F.2d 415 (C.A. 2, 1961).

The decision below is also in conflict with numerous decisions of lower federal courts. In *Prudential Insurance Co.* v. *S.E.C.*, 326 F.2d 383 (C.A. 3, 1964), *cert. denied*, ... U.S. ....., 84 S. Ct. 1629 (1964), the court started "with the premise that securities legislation must be broadly construed * * * to insure [investors] a full measure of protection," and concluded:

> "The Investment Company Act of 1940 contains significant safeguards for the protection of those who, like the purchasers of variable annuities, invest in 'securities.' These safeguards, characterized by the Commission as insuring 'corporate democracy,' include disclosure of investment policy and operating practices, and the regulation of fees, * * *. The mere fact that the investment program * * * is under the aegis of an insurance company [or in this case a "trustee"] ought not to negate compliance with these controls in the absence of compelling circumstances. We find no such circumstances here." 326 F. 2d 383, 386, 388.

Nor did the court below find, or even look for, such circumstances here.

The need for and implementation of a broad construction of the 1940 Act particularly with respect to eliminating or mitigating conflict of interest and self-dealing by those in control of investment companies is also exemplified in *Chabot* v. *Empire Trust Company*, 301 F. 2d 458 (C.A. 2, 1962); *Aldred Investment Trust* v. *S.E.C.*, 151 F. 2d 254 (C.A. 1, 1945), *cert. denied*, 326 U.S. 795 (1946); and *cf. Taussig* v. *Wellington Fund, Inc.*, 313 F. 2d 472 (C.A. 3, 1963), *cert. denied*, 374 U.S. 806.

The court below did not interpret the Act so as "to mitigate, and so far as is feasible, to eliminate" conflict of interest and self-dealing as required by Congress in §1(b). Nor did the court below interpret the Act in accordance with its dominant purpose as required by this Court in *Variable Annuity, supra*, and other decisions of this Court and lower federal courts cited above. It is respectfully suggested that this Court exercise its supervisory powers and overturn the decision below so that a large segment of small investors will not be denied the protection that Congress plainly intended such investors to have.

CONCLUSION

For the reasons heretofore set out, petitioners respectfully request that this Court issue a writ of certiorari to the Supreme Court of Delaware and reverse the judgment of that court.

Respectfully submitted,

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August 14, 1964

APPENDIX.

IN THE
SUPREME COURT OF THE STATE OF DELAWARE

SIDNEY C. KLEINMAN and JANICE R. KLEINMAN,
Objectors-below,
Appellants,
vs.
HYMAN SAMINSKY and BETTY SIEGEL, Trustee for Joan Siegel,
Plaintiffs-below,
Appellees,
and
CHARLES C. ABBOTT, WILFRED GODFREY, J. LEE POTTER, ORA C. ROEHL, ERWIN H. SCHELL, SIDNEY L. SHOLLEY, CAMERON S. THOMPSON, SAM G. BAGGETT, GLENN N. LEMPEREUR, KEYSTONE CUSTODIAN FUNDS, INC., KEYSTONE CUSTODIAN FUNDS, INC., as Trustee, and THE KEYSTONE COMPANY OF BOSTON,
Defendants-below,
Appellees.

No. 80, 1963.

(April 22, 1964)

TERRY, *C.J.*, WOLCOTT and CAREY, *JJ.*, sitting.

Appeal from the Court of Chancery in and for New Castle County.

WOLCOTT, *J.:*

This is an appeal from the approval by the Chancellor of an agreement settling a derivative action brought on behalf of the ten Keystone Custodian Funds (hereafter

"the Funds") against the Trustee of the Funds, Keystone Custodian Funds, Inc., (hereafter "Keystone"), its directors, and The Keystone Company of Boston (hereafter "Keystone of Boston"), a wholly-owned subsidiary of Keystone, and the sole underwriter of certificates of participation in the Funds. Both corporate defendants are Delaware corporations.

The Funds are ten common law trusts created in 1935. Each fund is an open-end investment company registered as such under the Investment Company Act of 1940 (19 U.S.C., §§80a-1, *et seq.*), (hereafter the "Act"). Each fund differs from the others in the matter of investment portfolios and objectives. Under the trust agreements creating the Funds the certificate holders cannot vote for the election of a board of directors. In fact, the Funds has no board of directors as such.

The ten funds each exist under a separate trust agreement. Keystone is the trustee under each of the trust agreements. Under the terms of the trust agreements Keystone performs all of the investing management and administrative services required by the Funds. In return for its services the trust agreements provide for the annual payment to it of a management fee of ½ of 1% on the first $150,000,000 in aggregate assets and of ⅜ of 1% on aggregate assets in excess of that amount. The trust agreements provide for the payment to Keystone of an annual "recurring charge" of ¼ of 1% in lieu of all operating and administrative expenses.

Certificates of participation in each of the funds are offered for sale by Keystone of Boston pursuant to a principal underwriting contract between Keystone and Keystone of Boston. The holder of a certificate of participation by reason of his purchase becomes a party to the

trust agreement governing the fund in which he participates.

As a result of the operation of the Funds its net assets grew from approximately $282,500,000 in 1952 to approximately $677,760,000 in 1962. Keystone's management fee grew from approximately $1,100,000 in 1954 to approximately $2,650,000 in 1962, and the recurring charge collected by Keystone grew from approximately $600,000 in 1954 to approximately $1,645,000 in 1962. In June of 1963 the net assets of the Funds totaled more than $770,000,000.

Keystone of Boston, wholly owned by Keystone, the sole distributor of the certificates of participation of the Funds, pursuant to its agreement with Keystone, charged the purchasers a sales load or commission equal to 8.3% of the sales price on all sales up to $25,000 and smaller percentages on larger sales. For the period 1954 to 1962 the net return to Keystone of Boston has ranged from approximately $929,000 to $2,895,000.

This action was instituted on behalf of the Funds and charged that the defendants had committed waste of the Funds' assets by causing the payment of excessive management fees and recurring charges; that defendants had breached their fiduciary duty by awarding the underwriting contract to Keystone of Boston, and that the underwriting contract and management fee schedule were void because they had not been submitted to the certificate of participation holders for approval as required by the Act.

Defendants answered denying any wrongdoing and moved for summary judgment based upon the pleadings, affidavits, exhibits and depositions. Defendants' motion for summary judgment was granted in part and denied in part by the Chancellor. *Saminsky* v. *Abbott*, 185 A.2d 765.

The Chancellor held that the fact that the trust agreements in question provided for a schedule of fees to Keystone, the trustee, did not estop the investors in the Funds from objecting to allegedly excessive compensation to the trustee under the principles of *Rogers* v. *Hill*, 289 U.S. 528, 53 S.Ct. 731, which he held to be applicable to those common law business trusts. He also held that such amount of the recurring charges as could be demonstrated to be in excess of the actual operating expenses of the Funds should be considered as additional compensation to Keystone. However, the Chancellor reserved for trial on the merits the factual determination of these issues.

With respect to the underwriting contract with Keystone of Boston, the Chancellor held the contract void as a violation of the Act for the failure to submit it periodically for shareholder approval as required by the Act. With respect to the argument made by plaintiffs to the effect that Keystone was acting as investment adviser of the Funds in violation of the Act, the Chancellor gave judgment for the defendants.

We point out that the correctness of none of these holdings of the Chancellor is before us in this appeal for the reason that the appeal is from his approval of an agreement of settlement of the action brought about in part at least by these rulings. Neither side to the appeal seeks review of the correctness of his rulings made in his first opinion.

Following the Chancellor's decision, leave was granted the defendants to file further affidavits and a brief in support of their original motion. Prior to reargument of the summary judgment motion, the holders of the certificates of participation of the Funds at a meeting called for the purpose overwhelmingly ratified and approved all

payments to Keystone of management fees and recurring charges, and further approved a new underwriting contract between Keystone and Keystone of Boston, at the same time ratifying and approving the past underwriting contracts and transactions under them. More than 90% of the certificate holders of each fund voted for ratification. There is no contention made that Keystone failed to make full disclosure of the matters the certificate holders were being asked to ratify and approve.

Thereafter, negotiations between the parties resulted in an agreement of settlement. In brief, the settlement agreement provided for a scaled-down schedule of management fees and recurring charges which, on the basis of net assets of $771,000,000 at the time of settlement, amounted to an annual savings to the Fund of in excess of $250,000. The agreement of settlement also provided that the certificate holders would have the permanent right to reject any increase in compensation proposed by Keystone, and that for a period of eight years Keystone would not seek any increase in compensation unless a change in circumstances made its compensation unreasonably low and the Chancellor granted leave to Keystone to submit the proposed increase to the certificate holders.

Pursuant to Rule 23 of the Court of Chancery, the proposed settlement was set down for hearing and the certificate holders of the Fund given notice. Only the appellants appeared at the hearing as objectors and offered in opposition the testimony of an economist who characterized the proposed settlement as unfair. The Chancellor approved the settlement and from that approval this appeal is taken.

Recently, in *Rome* v. *Archer*, 197 A.2d 49, we had occasion to restate the function of this court on appeal from

an approval of the settlement of a derivative action. We pointed out that we review the record for the sole purpose of determining whether or not under the circumstances the approval of the Chancellor of the settlement was an abuse of his discretion, and that in order to make a finding that he abused his discretion the evidence must be strongly to the contrary. We approach the decision in this appeal in the light of this limitation.

Appellants argue that there was no evidence properly before the Chancellor except the testimony of their expert witness who characterized the settlement as unfair. We think not, however, for at the hearing the Chancellor ruled that the entire record was before him for the purpose of passing on the settlement. The appellants argue there was no actual offer into evidence of the depositions, exhibits, etc. However, these were all before the Chancellor and he obviously decided the case upon them. To argue that because no formal offer into evidence was made the matters contained in the record may not be considered, is to stand upon too narrow a technicality, particularly in view of the Chancellor's statement from the Bench that he would decide the case upon everything on file. The point is without merit.

Next, appellants argue that since the Funds as such had no board of directors and since the directors of Keystone, the trustee, performed the functions of a board of directors of the Funds, it follows that the individual defendants are at one and the same time directors of the investment adviser, Keystone, and of the Funds in violation of §10(a) of the Act which prohibits more than 60% of such a board from being "affiliated" with the investment adviser. It is therefore argued that the complaint set forth a valid enforceable claim under the Act which was improvidently given up by the settlement.

In the first place, Keystone is not the investment adviser of the Funds. It is the trustee. As such, therefore, it is excluded in terms from the statutory definition of an investment adviser found in §2(a)19 of the Act. Furthermore, there is in existence no investment advisory contract between Keystone and the Funds which, under §15(a) of the Act, must by law be approved by a majority of the shareholders.

In the second place, since the Funds do not have an investment adviser within the meaning of the Act, it follows that there is none with whom directors of the Funds could be "affiliated" within the prohibitory limits of §10(a) of the Act. Furthermore, it is obvious to us that the relationship between Keystone and the Funds and its certificate holders is that of trustee and beneficiary. The propriety of this relationship under the Act seems to be recognized by §16(b).

The whole of appellants' argument based upon the Act seems little more than an attempt to distort the true nature of the Funds and Keystone into a mold which would fit neatly into one of the prohibited areas of the Act. The difficulty is, however, that the argument in reality is a complaint that the Congress did not pass the Act in a form more acceptable to appellants.

Next, appellants argue that since Keystone was at the same time trustee and adviser of the Funds, an improper conflict of interest existed which will be perpetuated by the settlement. The difficulty with the argument is that this situation existed at the time the certificate holders acquired their interest in the Funds. It is true, of course, that the compensation arrangement was in no sense a negotiated one, but this, too, was obvious to any investor in the Funds. There is no rule of common law we know of which

makes such an arrangement invalid. The usual rule prohibiting trustees from self-dealing, we think, has no application to this arrangement set up by contract and of which the investor knew when he acquired his interest in the Funds.

Appellants argue that since the complaint charges a waste of the Funds' assets, making applicable the rule of *Rogers* v. *Hill, supra,* the ratification by the certificate holders is entitled to no consideration. While the doctrine of *Rogers* v. *Hill* was held to be applicable in this case if the facts of waste were established the Chancellor in *Saminsky* v. *Abbott, supra,* reserved for future determination what these facts were. Such determination was forestalled, however, by the agreement of settlement. The allegation of waste in the complaint, however, does not, of itself, establish a waste of assets. It is quite apparent to us that the Chancellor considered the charge of waste and was of the opinion that, even if successfully established, it was doubtful at least that the ultimate recovery would have exceeded the settlement gains. Having reached this conclusion, it was proper for the Chancellor to give to the shareholders' ratification some consideration. *Saxe* v. *Brady,* 184 A.2d 602. At the very least, such ratification demonstrates that reasonable businessmen might differ upon the propriety of the settlement in which event the duty of the court is to approve the settlement. *Rome* v. *Archer, supra.*

Finally, appellants argue that the management fees and recurring charges established by the settlement agreement are excessive and are noncompetitively established. The answer to this contention is that the fees and charges paid by the Funds when compared to the fees and charges of other investment companies which have been approved by

the courts are not only in line but are less. See *Saxe* v. *Brady, supra,* and *Acampora* v. *Birkland,* 220 F.Supp. 527. If this comparison is not conclusive of the matter, yet it casts a heavy doubt upon the ability to press the claim for excessive compensation to a successful conclusion. So heavy is this doubt, in fact, that alone it justifies the approval of the settlement by the exercise of business judgment.

Appellant, however, argues that a comparison with the fees paid by other investment companies is meaningless because none of the fees has been established competitively. It seems to us, however, that generally speaking the fact that all such fees show a pattern of uniformity suggests strongly that they have been established by forces which, in a sense, are the equivalent of competition. Furthermore, appellants do not suggest any means of using competition to establish fees, nor can we think of one. The economic facts preclude it.

We conclude, therefore, that the appellants have failed to demonstrate any illegality in the structure of this investment operation, or to demonstrate that the complaint sets forth a cause of action for excessive compensation or waste of assets which had any reasonable probability of ultimate success in the event of trial on the merits. This being so, the approval of the settlement by the Chancellor was a proper exercise of business judgment.

The judgment below is affirmed.

INVESTMENT COMPANY ACT OF 1940

Findings and Declaration of Policy

* * *

Sec. 1. * * * (b) Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission made pursuant to section 30 of the Public Utility Holding Company Act of 1935, and facts otherwise disclosed and ascertained, it is hereby declared that the national public interest and the interest of investors are adversely affected—

* * *

(2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders;

* * *

It is hereby declared that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors.

General Definitions

Sec. 2. (a) When used in this title, unless the context otherwise requires—

(1) "Advisory board" means a board, whether elected or appointed, which is distinct from the board of directors

or board of trustees, of an investment company, and which is composed solely of persons who do not serve such company in any other capacity, whether or not the functions of such board are such as to render its members "directors" within the definition of that term, which board has advisory functions as to investments but has no power to determine that any security or other investment shall be purchased or sold by such company.

• • •

(12) "Director" means any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated, including any natural person who is a member of a board of trustees of a management company created as a common-law trust.

• • •

(19) "Investment adviser" of an investment company means (A) any person (other than a bona fide officer, director, trustee, member of an advisory board, or employee of such company, as such) who pursuant to contract with such company regularly furnishes advice to such company with respect to the desirability of investing in, purchasing or selling securities or other property, or is empowered to determine what securities or other property shall be purchased or sold by such company,

• • •

Affiliations of Directors

Sec. 10. (a) After one year from the effective date of this title, no registered investment company shall have a board of directors more than 60 per centum of the members of which are persons who are investment advisers of, affiliated persons of an investment adviser of, or officers or employees of, such registered company.

• • •

(h) In the case of a registered management company which is an unincorporated company not having a board of directors, the provisions of this section shall apply as follows:

(1) the provisions of subsection (a), as modified by subsection (e), shall apply to the board of directors of the depositor of such company;

• • •

Investment Advisory and Underwriting Contracts

Sec. 15. (a) After one year from the effective date of this title it shall be unlawful for any person to serve or act as investment adviser of a registered investment company, except pursuant to a written contract, which contract, whether with such registered company or with an investment adviser of such registered company, unless in effect prior to March 15, 1940, has been approved by the vote of a majority of the outstanding voting securities of such registered company and—

(1) precisely describes all compensation to be paid thereunder;

(2) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company;

(3) provides in substance, that it may be terminated at any time, without the payment of any penalty, by the board of directors of such registered company or by vote of a majority of the outstanding voting securities of such company on not more than sixty days' written notice to the investment adviser; and

(4) provides, in substance, for its automatic termination in the event of its assignment by the investment adviser.

• • •

(d) It shall be unlawful for any person—

(1) to serve or act as investment adviser of a registered investment company, pursuant to a written contract which was in effect prior to March 15, 1940. after March 15, 1945, or the date of termination provided for in such contract, whichever is the prior date, or after assignment thereof subsequent to March 15, 1940, by the person acting as investment adviser thereunder; or

(2) as principal underwriter for a registered open-end investment company to offer for sale, sell, or deliver after sale any security of which such company is the issuer, pursuant to a written contract which was in effect prior to March 15, 1940, after March 15, 1945, or the date of termination provided for in such contract, whichever is the prior date, or after assignment thereof subsequent to March 15, 1940, by the person acting as principal underwriter thereunder:

Provided, however, That the limitation to March 15, 1945, shall not apply in either case if prior to that date such contract is renewed in such form that it complies with the requirements of subsection (a) or (b) of this section, as the case may be, and is approved in the manner required by this section in respect of a contract of the same character made after March 15, 1940.

(e) In the case of a common-law trust of the character described in subsection (b) of section 16, either written approval by holders of a majority of the outstanding

shares of beneficial interest or the vote of a majority of such outstanding shares cast in person or by proxy at a meeting called for the purpose shall for the purposes of this section be deemed the equivalent of the vote of a majority of the outstanding voting securities, and the provisions of paragraph (40) of section 2 (a) as to a majority shall be applicable to the vote cast at such a meeting.

• • •

Changes in Board of Directors; Provisions Relative to Strict Trusts

Sec. 16. (a) No person shall serve as a director of a registered investment company unless elected to that office by the holders of the outstanding voting securities of such company, at an annual or a special meeting duly called for that purpose;

• • •

(b) The provisions of subsection (a) of this section shall not apply to a common-law trust existing on the date of enactment of this title under an indenture of trust which does not provide for the election of trustees by the shareholders.

• • •